

Damages Awards for Wrongful Imprisonment Should Be Tax-Free

By Robert W. Wood

A person is arrested, convicted, spends time behind bars, is later exonerated and then seeks redress for his injuries. Although no amount of money can wash away years of wrongful confinement, damages for wrongful imprisonment can ease the pain. Amazingly, it isn't clear if such awards are taxable, but a recent case suggests they are. I believe that is unconscionable.

Damages for personal physical injuries or sickness are not taxable, but the IRS says "observable bodily harm" must be present for an

exclusion to be available. It is hard to imagine a more compelling case for tax-free treatment than being confined behind bars. Even if no bruises or broken bones befall the plaintiff, it is axiomatically physical to be confined.

Plus, any long-term false imprisonment case usually involves ancillary claims. Whether characterized as assault, battery or medical malpractice, most long-term inmates have altercations that can provide the proverbial physical hook on which to hang more general deprivation of liberty claims. Yet even without extra physical trauma, the act itself manifests injury.

Historically, helpful tax authority

can be found concerning payments to Japanese-Americans in internment camps during World War II, survivors of Nazi persecution and U.S. prisoners of war in Korea. All of such recoveries were ruled nontaxable payments for a deprivation of liberty. Nevertheless, the IRS recently said these authorities are obsolete unless you can show observable bodily harm.

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A recent U.S. Tax Court case, *Daniel J. and Brenda J. Stadnyk v. Commissioner*, T.C. Memo 2008-289, could skew the law in an inappropriate direction. Brenda Stadnyk bought a used car, was unhappy with it, tried to return it and eventually stopped payment on her check. Although her stop payment cited "dissatisfied purchase," Bank One incorrectly stamped her check "NSF" (non-sufficient funds).

The car dealer filed a criminal complaint against Stadnyk, and the sheriff arrested her before family and friends. She was detained, handcuffed, photographed and confined. Several hours later, she was transferred to a county jail, where she was searched, required to undress, remove her brassiere in the presence of police officers, and don an orange jumpsuit.

After eight hours, she was released on bail. Several months later, she was indicted on bad check charges, but the charges were dropped. Stadnyk sued the dealership and the bank for malicious prosecution, abuse of process, false imprisonment, defamation and outrageous conduct.

After mediation, Stadnyk settled for \$49,000. Stadnyk's attorney, the mediator, and the bank's attorney all stated definitively there would be no tax. Nevertheless, Stadnyk received an IRS Form 1099 for the payment. She failed to report it as income and eventually landed in Tax Court.

Stadnyk was physically restrained against her will and subjected to police arrest procedures, but admitted she did not suffer any physical injuries. She was not grabbed, jerked around, bruised or physically harmed, though she did visit a psychologist eight times over two months as a result of the incident. Stadnyk argued that physical restraint and detention by itself constitutes a physical injury.

The Tax Court flatly disagreed: "Physical restraint and physical detention are not 'physical injuries'... Being subjected to police arrest procedures may cause physical discomfort. However, being handcuffed or searched is not a physical injury ... [n]or is the deprivation of personal freedom a physical injury."

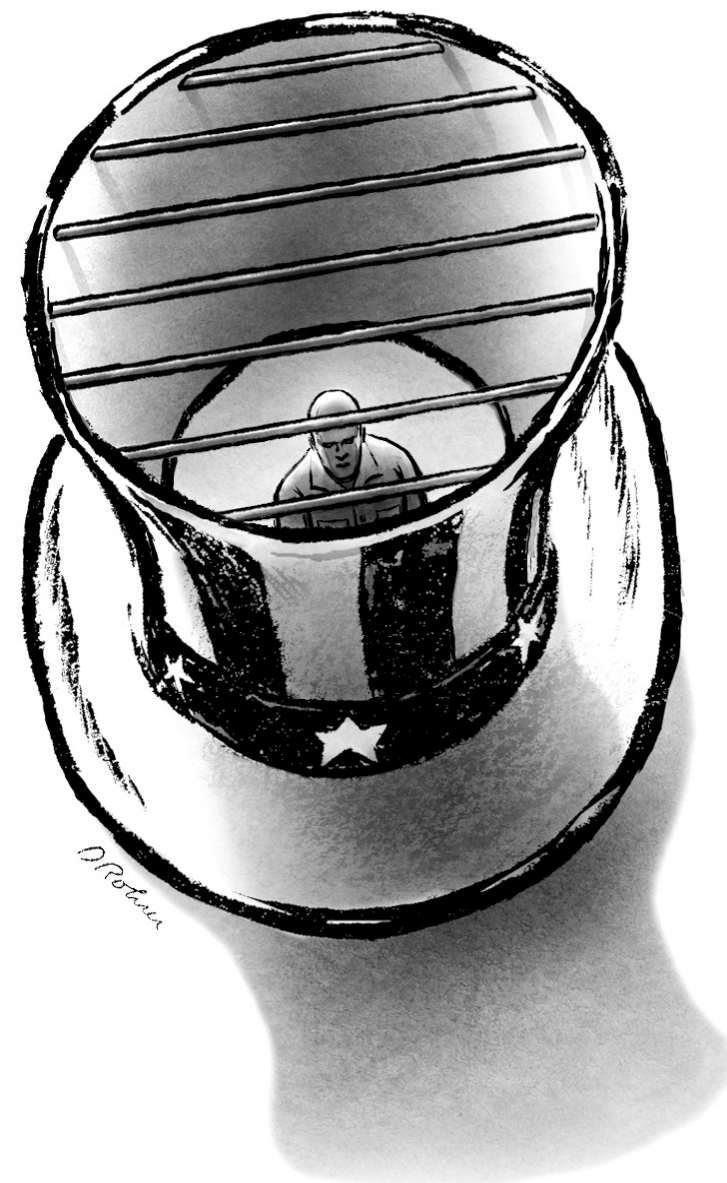
Viewing physical restraint as "mental," the Tax Court ruled Stadnyk's settlement taxable.

Reasonable people might differ over whether this particular settlement for an eight-hour false imprisonment should be taxable. But the Tax Court's platitudes about *all* false imprisonment are wrong and dangerous.

Being locked behind bars may well lead to mental damages. Clearly, though, the primary thrust of a false imprisonment claim is not mental.

Even if you are handled with kid gloves, confinement is physical. Besides, can anyone seriously compare Stadnyk's experience to that of an exonerated who is wrongfully convicted and wrongfully imprisoned in a penitentiary for, say 10 years?

I don't see how. Even if you believe Stadnyk's recovery is not physical enough to be tax-free, *serious* false imprisonment cases are different. One way to distinguish serious cases involving long tenure in prison relates to ancillary claims. Stadnyk suffered indignities, but



she was not bruised, pushed or manhandled.

In contrast, in long-term incarcerations, there is almost always physical trauma (often leaving permanent scars), battery claims, medical malpractice claims and more. Yet as a matter of analytical purity, it is worthwhile to ask what would happen if the tax consequences of a payment in settlement of a wrongful long-term incarceration case were considered in isolation. Even without the presence of ancillary claims for separate torts, and even without the customary

damages usually accompanying those torts, such a recovery should itself be tax-free.

Stadnyk is an unfortunate and incorrect decision, even on its facts. If its platitudes about all false imprisonment recoveries are heeded, it will lead to incorrect and unjust tax results.

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